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*Transfer pricing is not just about taxation, it's about understanding the added value in all of an organisation's transactions*

**A discussion of Areopa's approach to intellectual capital accounting in support of value related transfer pricing**

# INTRODUCTION

## Drawbacks with transfer pricing now and in yesteryear

### *A short history*

In the years leading to the end of the 20th century, transfer pricing was almost always associated with the exchange of goods between different divisions or subsidiaries of the same organisation. The base for determining an acceptable transfer price was the sum of direct costs and variable overhead (or full costs in some cases) with a margin or a mark-up added to cover other costs and give some profit to the originating division or subsidiary.

There was rarely any consistency in application. Transfer prices from the supply units, such as component factories or production units, to assembly or sales units were calculated differently depending on whether it related to deliveries to a new unit or delivery of a new product to a unit where there was already an established relationship. Depending on the maturity and profit situation of the receiving units, transfer prices were set up differently.

Quite possibly there were good business reasons for such variability. As long as they were well understood within the organisation's management circles and performance measurement criteria reflected the differences, it didn't present much of a problem. Unfortunately, with the spread of globalisation the exchange of goods between different units of the same organisation intensified raising the issue of transfer pricing higher on the management team's agenda.

From the discussions and debates on this developing business problem came an opinion that suggested transfer prices should be equal for all receiving entities. But why? The circumstances surrounding each and every situation requiring a transfer price was likely to be different. How could an identical transfer price be acceptable in all cases?

The vagaries of transfer pricing was becoming a topic of interest in places other than in the offices of an organisation's managers. Transfer pricing was being seen as a vehicle for manipulating profits resulting in problems with the taxation authorities in the supplying or receiving country, or both. This was particularly noticeable when there were significant differences in the marginal tax rates of the countries involved. Taxation, in all its forms, now started to be the most significant factor in determining transfer prices.

No matter what was being transferred from one unit to another across jurisdictional boundaries, tax authorities were asking pointed questions about the transfer price – what was the underlying cost of the item being transferred and what was the margin or mark-up and how was it determined? Initially lacking clear rules or understanding, these investigations placed organisations under increasing pressure to justify transfer prices. The outcome, in many instances, was artificial transfer

prices determined to satisfy the tax authorities. This resulted in the distortion of business results leading to imperfect or unreasonable business decisions.

With the passing of time the structure of organisations, whether local, regional, national, multinational or transnational, and the nature of their operations changed. These changes resulted in a streamlining of business processes, usually by way of simplification and standardisation. Organisational doctrine insisted on a focus on core activities, which led to an increase in outsourcing and sub-contracting, particularly between units of the same parent organisation. The outcome, quite naturally, was an increased focus on transfer pricing principles and their meaning.

One area in particular, that of research and development, suffered from "traditional" transfer pricing policies. They led to an imbalance between investment, costs and profit as a result of a failure to reflect the impact of intellectual capital (IC) and how it added value to products and services. This situation also led to an increasing number of disputes with the tax authorities because the old principles were no longer always valid. As a result there has, in recent years, been quite some development activity in respect of transfer pricing.

> ***The last 10 years have created situations where central, or individual unit, sponsored improvements have reduced the overall cost of doing business. Equally, increasing costs, such as fixed costs or intellectual capital creation costs, in the supplying unit have provided significant long-term savings for that unit. Unfortunately, the current way of defining transfer prices means that the receiving unit makes a greater profit without contributing to the reasons for this profit.***

## How may an intellectual capital calculation approach to transfer pricing better steer business decisions?

Developed in 2000 as a way of identifying the elements of IC and understanding their potential organisational risk, Areopa's approach to IC accounting is capable of acting as a frame of reference for value related transfer pricing while at the same time eliminating many of the elements of risk. One of Areopa's key tenets is that costs do not necessarily relate to revenue or profit. Creating IC incurs costs but also creates a resource that will generate future revenues and profits.

> ***With Areopa's concept of and solution to intellectual capital accounting, an organisation can better steer its process and knowledge improvement. What is more, it can act as true base for a new kind of transfer pricing…one that is fairer to all parties in this rapidly changing business environment.***

# AREOPA, INTELLECTUAL CAPITAL AND TRANSFER PRICING

## Concept of intellectual capital and how it affects transfer pricing

### *The challenge*

The foundations of the global economy have now shifted from an industrial base to a service and knowledge base. This shift is nearly complete in the West, and is rapidly occurring around the world. The AREOPA Intellectual Capital Calculation (ICC)® model addresses most of the changes in information requirements in this service dominated environment. These include IC definitions, management practices, accounting and auditing. We enable the enterprise to implement intellectual capital management (ICM) practices that are the key to success in a global service economy.

The importance of physical and financial assets in the determination of a company's market value is diminishing as non-financial, especially intangible, assets become the main drivers of performance and market value. AREOPA has developed models, methodologies and tools for identifying and quantifying intangibles as components of IC.

> ***Innovation accounts for more than half of productivity growth worldwide and IC is the mother of innovation. As a key driver of economic value for every company, IC must be identified, managed, measured and protected.*** (Source: Gartner Research)

### *What is intellectual capital management?*

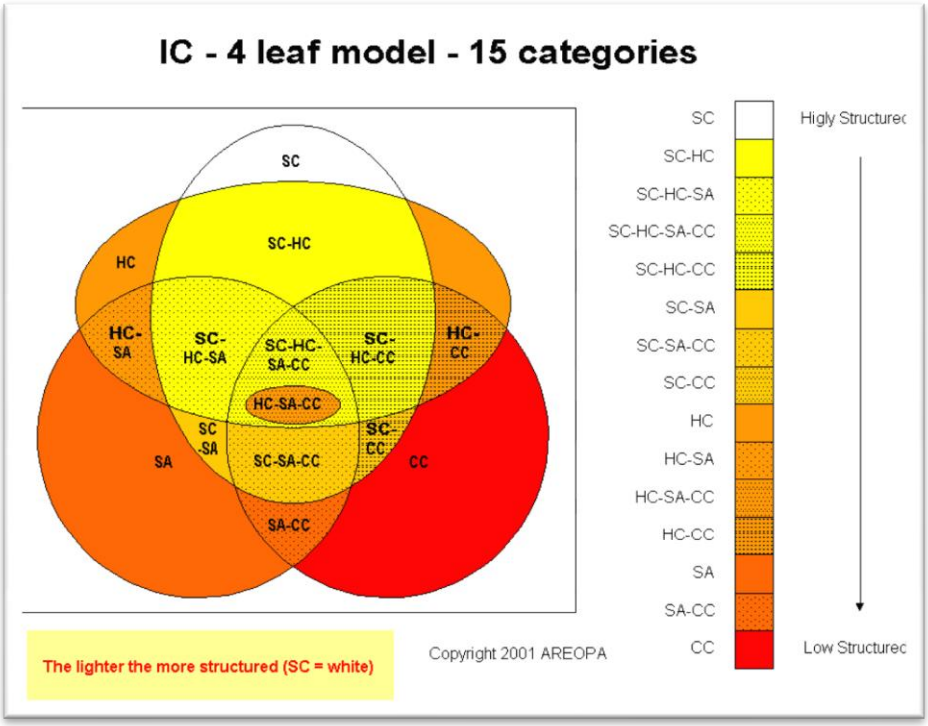
Managing these vital intangible assets, especially intellectual assets such as human capital, structural capital, customer capital and alliance capital, is a challenge for managers. This can be particularly awkward when you consider that only a small portion of these intellectual assets, a part of the explicit IC that is intellectual property, may be legally protected. What is needed is a disciplined approach to identify and productively employ all forms of IC with a view to creating economic value for an organisation. ICM provides such an approach and in so doing gives senior managers a way of turning comments such as "people are our best asset" from lip service into reality.

### *Areopa's 4-Leaf model, methodologies and tools® and Areopa's IICaRuS intellectual capital accounting model, methodologies and tools*

It has long been said that you can't manage what you can't measure. Successful managers must be able to focus their attention on factors that are critical in establishing and maintaining their competitive edge. A model that will account for an organisation's IC provides a powerful management tool. Areopa's models identify the sources of intellectual assets, both explicit and tacit, in any form of organisation whether that is a commercial enterprise, a not-for-profit organisation or a government agency. In addition they evaluate the return on ***all*** forms of capital.

Providing a monetary value clarifies the value and the impact of IC for managers and provides guidance as to how and where they should put their attention to increase the value of IC. What is more, in commercial organisations it helps to explain the difference between the book value and the market value of an organisation.

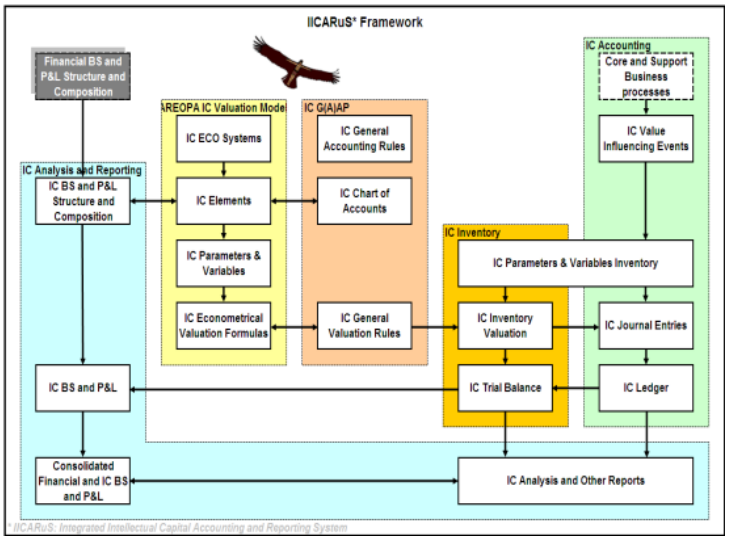
As previously mentioned, the four primary classes of IC are human capital (HC), structural capital (SC), customer capital (CC), and strategic alliance capital (SA). The last of these reflects the fact that partnerships, alliances and networks are increasingly important factors for business in a service oriented economy. Areopa's 4-leaf model, pictured below, shows how these primary classes interact with one another and create secondary classes represented by various combinations of the primary classes.




Tom Stewart, in his 1997 book *Intellectual Capital: The New Wealth of Organizations*, explains that HC, CC and SA are all a form of ***shared*** capital. This may be explained in the following ways. HC is "rented" from the individual human beings, who are usually employees but may also be contractors, who own it. When people leave an organisation they take their skills, competence, reputation and potential along with them. Similarly, when a customer takes their business elsewhere, or when an alliance breaks up, the customer's revenue potential or alliance's leverage is lost.

It is important for organisations to know where their IC is situated and which actions need to be taken to convert IC that is at risk of being lost into structural IC, i.e. to optimally structuralise its human, customer and strategic alliance capital.

IICaRuS, a schematic of which is pictured below and stands for *Integrated Intellectual Capital Accounting and Reporting System*, uses IC calculations derived from the 4-leaf model as inputs produces outputs in the same format as normal financial reporting with income statements and balance sheets. With the IICaRuS model we are able to account and report on all the IC assets and liabilities of an organisation. The Areopa approach has been recognised by the accounting profession as conforming to International Accounting Standards, especially IAS 36 (Impairment of assets) and IAS 38 (Intangible assets).




This leads us to ponder how IICaRuS can help in taking decisions related to IC in general and to transfer pricing in particular? Perhaps we can help by answering a few hypothetical questions.

*We need to close one of our subsidiaries, but which one should we close and why?*
The AREOPA method calculates the added value of organisations to enable like with like comparisons to be made. It also indicates ways to increase that value, as well as calculate the return on any investment you make.

*We are on the verge of acquiring a company. Where can we find value as well as problems?*
AREOPA's models, methodologies and tools provide a clear on view how and where the value is created and sustained, as well as guidance on how and where the company can create more added value.

*Do new ideas trigger a focus on costs rather than clearly quantified benefits?*
The AREOPA method teaches your organisation to think first in terms of benefits rather than simply thinking of costs. By combining both elements the real added value can be calculated so it will help the organisation to better benchmark their ideas.

*Are my employees' networks tacit or explicit?*
The AREOPA models, methodologies and tools calculate the value of existing networks and suggest ways to make those networks more structural, in other words explicit, so they do not leave when individuals leave.

*What is the value of plans made and what effect did the planning have on the execution? What is the added value, explicit and tacit, created by these plans and actions?*
Planning should always be detailed and written down if we want the execution undertaken in a way that the added value would be predictable. AREOPA's models, methodologies and tools calculate the added value potential of a plan and created added value as a result of its execution. It follows then that by examining the differences between the expected added value (planning) and the created added value (execution) it is possible to identify the good and bad points of your business processes.

*Do you know what the value of the decision-making process is in your company?*
AREOPA can calculate the value, both in terms of efficiency and effectiveness, of the decision-making process. In so doing you will get a clear view on how to improve that value.

*Why should we include intangible assets in our balance sheet?*
AREOPA can help you build a sound financial motivation for including intangible assets on your balance sheet.

*Have your investments in knowledge management led to better performance?*
AREOPA calculates the value of the use of know-how, by identifying both benefits and costs.

*Is the value of your candidate for Chief Executive Officer really one million euro?*
AREOPA's models, methodologies and tools calculate the value of a candidate based on personal network, knowledge, skills, home support and other elements which are classically not found in candidate valuation models, methodologies and tools.

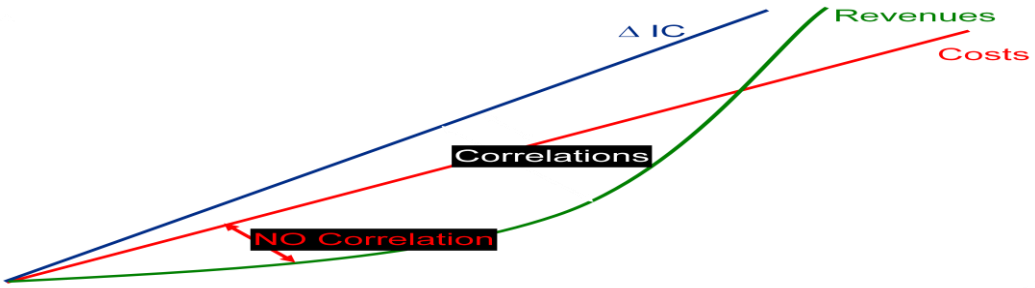
*How can you quantify, in monetary terms, all the intangible elements of every transfer pricing requirement in your organisation?*
AREOPA's tools to calculate the value of each transfer pricing event is based on quantifying the added value creating phenomena which are instrumental in each transaction. All the variables and parameters, which are components of the added value creating phenomena, are measured in a standard auditable way based on validated and normalised data. Their application results in an acceptable transfer price that is scientific and mathematically correct.

> ***For multinationals to enjoy a benign tax environment, scientifically validated transfer pricing is one of the most critical success factors. However, until today, nobody other than Areopa has been able to provide a monetary value for the intangible part of the transfer pricing elements that is sustainable, validated and accepted by the revenue authorities.***

But transfer pricing is more than a tax issue. It is also used for other purposes such as motivating good decisions and providing information for the sensible evaluation of managers and organisations. Looked at this way, transfer pricing principles are applicable to every internal transaction in an organisation. This includes not only transactions between Head Office and subsidiaries or branches, but also transactions between departments and between process owners, hierarchy, and even individuals.

By focusing on added value, the use of Areopa's models brings other benefits to organisations. Among other things it creates an opportunity to use the added value calculation as part of planning and control of pricing issues, understanding risk spreads, identifying problem signals, and creating effective dashboards.

Also, by using this added value concept everywhere in an organisation it is possible to eliminate waste, which averages 15% of total costs, because Areopa's ICC model identifies those costs that add value to the IC of the organisation and those that don't. Using an added value cost calculation it is possible to predict future revenue increases based on changes in IC value (see the picture below).




While there are many advantages of using the added value concept there are also things to be wary of. For example, one particular phenomenon that is very well known in organisations is that of *rework* – that is doing things again which have been done before. In any detailed calculation of added value one has to be very careful not to quantify the rework as added value. In our calculations we can only take the added value into account once. The rest, the rework, even it has added value, is categorised as a cost of poor performance and by definition not an asset but an irrecoverable cost.

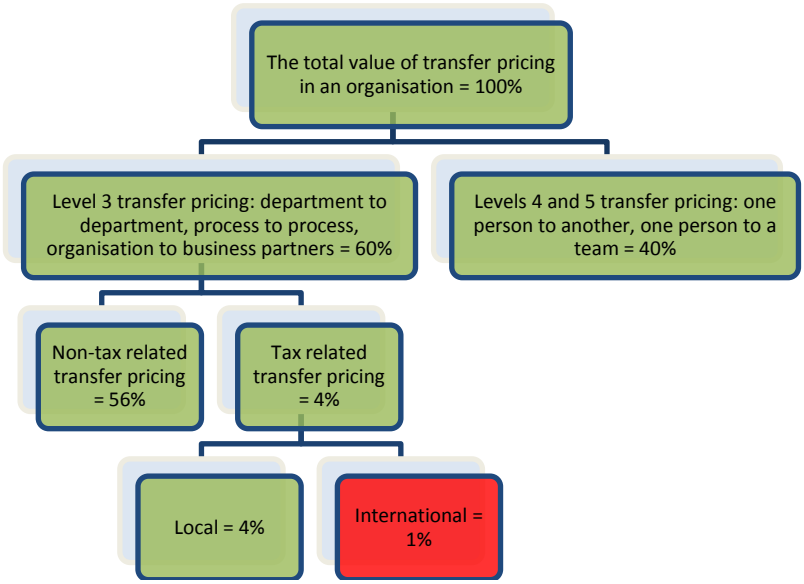
Let's stop there as we are moving away from the underlying reason for our white paper...a discussion on transfer pricing!

***The transfer pricing challenge***

A transfer pricing calculation using the Areopa ICC model provides a solution for the major questions that "cost driven" approaches leave untouched:

- The mystery of fixed costs. How do they contribute to added value? Nobody knows!
- How do costs create future profit? Nobody can prove it!
- And if they do, what is the impact of the costs?

We can picture the actual use of transfer pricing in the following way:




The transfer pricing philosophy espoused here for internal transactions is equally applicable to external transactions between organisations and their partners, suppliers, customers, and outsourcers.

> ***In the terms we have just discussed, once we look at the organisation in terms of transfer pricing it becomes clear that the total sum of all the elements of transfer prices in the organisation would be the total value of a company.***

By determining transfer prices based on Areopa's ICC calculation, it is possible to identify the *tacit knowledge* that is used in the organisation. Tacit knowledge is normally considered a liability because it can disappear at any time. However, by identifying it and quantifying it, we may be able to capture it, store it and make it transferable and reusable. By so doing, the risk of losing know-how may be reduced by as much as 35% and the tacit knowledge is converted it into *explicit knowledge*. As such, it now becomes an asset. Using this approach the critical mass of an organisation's transfer prices will be multiplied by as much as 13 times when compared with the transfer pricing method used today.

> ***Transfer pricing becomes a managerial tool creating a common language between managers and accountants. It also gives every manager the opportunity to manage their department not only in terms of costs incurred but also in terms of created added value based on comparative departmental transfer pricing results. It enables managers to use transfer pricing as a driver for creating added value in their department.***

## Elements of transfer pricing

### *Definition*

**Transfer Price = Costs + Added Value (IC)**

**Transfer pricing represents the quantification, in monetary terms, of all transactions in and between organisations based on level three business processes (hand off level). The objective is to combine "costs and added value (the IC)".**

### *Cost related elements*

Picture an organisation with a Head Office in one country that wishes to start a subsidiary in another. In addition to possibly goods and equipment, Head Office will deliver a lot of services and organisational know-how to the subsidiary during this start-up process. If we want to know the real value of Head Office's support for the subsidiary should we only consider the cost of these transactions? Indeed, what costs should we take into account? Just things like these:

- Manpower costs, managers' time, specialists' time, administrative time, information technology.
- External explicit or product costs, such as software, subcontractors, outsource companies, consultancy companies, law office work, and so on.
- Transmission costs, which is work done by Head Office for the subsidiary in the form of computer time and support services such as accounting.
- Cost of materials or assets transferred to the subsidiary?

One can only assume that the sum of all the costs related to transactions between Head Office and the subsidiary form part of the transfer price. But what if some of the transferred elements are not used in the subsidiary to create added value? What if the visiting managers only give the subsidiary managers "good advice"? Clearly, even if costs can be identified as being related to the transferred activities, we cannot be sure that all of the costs really do add value to the performance of the subsidiary. Does this mean that we then exclude the cost of the visiting manager as an element of the transfer price?

Accepting that some of the costs incurred by Head Office in transactions with the subsidiary **don't** add value and that others **do**, how do we make that distinction? It's easy to understand that the cost of running the Head Office manager's *Lamborghini* doesn't add much value to the performance of the subsidiary. Other costs are not so transparent. If we want to examine every cost associated with a transfer price to provide a list of those that add value and those that don't we need a more sustainable approach.

Using the measuring tools for the parameters and variables of the equations in the IICaRuS model that quantify added value in the IC calculation, Areopa has developed an evaluation system that will allocate costs into categories that do and those that don't add value.

***The added value (IC) related elements***

Let's consider a situation where you recruit five high level experts to set up your new subsidiary. Head Office pays for their salaries, benefits and all other employment related expenses. So, based on the cost concept of transfer pricing, Head Office will send an invoice to the subsidiary for all of these costs incurred for the five experts plus, perhaps, a small percentage to cover their administrative costs. Would that be right in the sense that the subsidiary considers this invoice as the cost of the added value they received? Now imagine these five experts don't get on with each other and they constantly quarrel. Instead of adding value to the subsidiary, they just create a lack of productivity, inaccuracy and the inevitable rework. If you were in charge of the subsidiary would you be prepared to pay this invoice? The answer is NO. What are we missing here? If the subsidiary only had to pay Head Office for the added value that these experts created, the payment would be much less than the costs.

In terms of a real transfer pricing concept it would be usual, in the case of high added value creation, for Head Office to invoice the subsidiary for not only the costs incurred on their behalf but also the added value created by their endeavours. The most important point is that a transfer price created in such a standardised and validated way, to include both costs incurred and added value, should negate any discussion between involved parties, such as operating units, tax authorities, customers, and subcontractors…about value. The key question that needs an answer is: how do we quantify the "added value" of a transaction or intervention?

Let's try to answer this with another example. Why is one software consultant worth more than another? The answer, in many cases, is that the first one knows more about the software package than the other. But if we follow the above reasoning on added value, we need to be able to identify the added value of the intervention on the part of each of the consultants. There is no direct correlation with costs in general but there is a correlation with the costs incurred to create the added value, such as training, study, knowledge sharing and the like. One thing is clear...if the value of the subsidiary goes up as a result of the intervention, the total value of the organisation will go up. This increase in the IC value of the organisation will be reflected in a higher stock value as long as it is correctly and transparently reported.

Considering its importance, let's now understand how added value is to be calculated. Added value may be expressed in IC value, which may be determined based on identification of the "added value creating phenomena" in the different fields of the IC calculation (human, structural, customer and alliance capital, and all

the combinations thereof that are identified in the Areopa 4-Leaf Model) and related to the transactions in a transfer pricing setting.

When we look at the IC created in a transaction, which will form the basis of calculation of a transfer price for that event, we find two kinds of IC:

1. ***Explicit IC***. This is IC which has been:
   a. captured
   b. stored
   c. made re-usable

In accounting terms explicit IC is an asset. This is because added value created in this way is not only usable by one person at one time but may be used by many people many times in this transfer price setting. It also means that explicit IC is owned by the organisation and not by an individual.

2. ***Tacit IC***. This is IC which is not explicit IC and is made up of things like:
   a. lessons learned from the one who is transferring knowledge or other input
   b. cases and stories (hidden learning elements)
   c. little methodologies or little tricks that are told by the one who transfers the knowledge

Tacit IC is never captured, written down or stored in a database. It only exists in the mind of the one who is transferring the knowledge. In accounting terms we speak about tacit IC as a liability simply because, if the one with the knowledge leaves the organisation, the added value created from this tacit IC also leaves. It means the added value created in situations like this is not owned by the organisation, but by the individual.

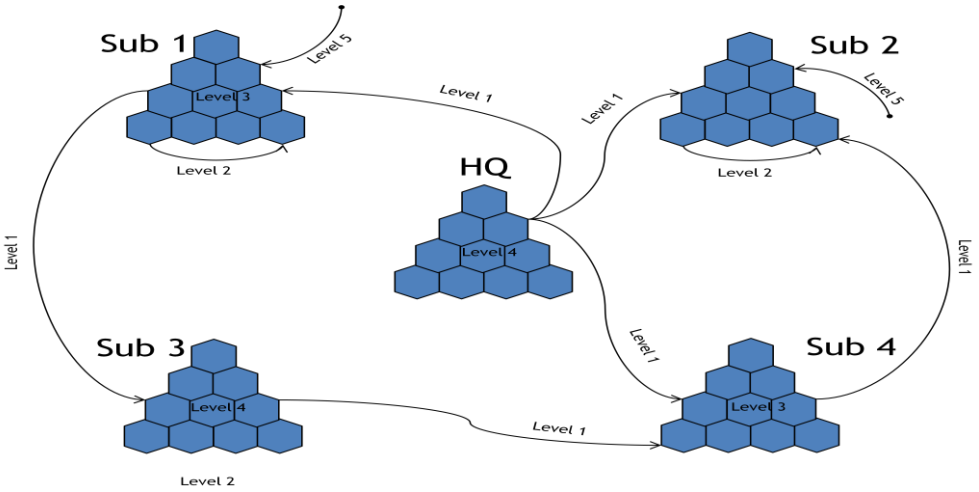
It is important that, in our transfer pricing calculations, we make a distinction between the explicit IC and the tacit IC so that, in the final determination of the transfer price, we only take the effect of explicit IC into account. Tacit IC, which we identified as a liability, can only have a value in the transfer price calculation if, in terms of managing, we are able to make the tacit IC explicit. In such circumstances the transfer price will go up based on well defined explicit added value creation.

A second dimension of added value creation centres on the **Present** versus the **Future**. Let's look at some examples.

If new instructions are given on how to deal with subcontractors, then these instructions will immediately create added value. On the other hand, when a new logistic system or process improvements are introduced, those actions will only create added value at a later stage when implementation is complete and the benefits verified. It is important that we take these two dimensions, present and future, into account.

In summary, when we are considering added value we shall recognise and calculate each of the explicit IC value and the tacit IC value of both the present and the future. This leads us to the final question, which is how do we calculate this IC added value so that it is usable in all of our transfer pricing transactions.

## How added value should be calculated with the Areopa's intellectual capital concept




Let us first consider the kind of transactions from which we want to calculate the IC added value. As we can see from the above schematic, it is possible for transfers of information, knowledge, human resource management, information technology, reporting systems, quality systems, data, experience, knowhow, and the like to exist on several levels:

- Level 1 : transactions between subsidiaries and Head Office and between subsidiaries
- Level 2 : transactions between different departments
- Level 3 : transactions within departments
- Level 4 : transactions between individuals
- Level 5 : transactions between external parties, such as customers, suppliers, partners, subcontractors, government, and auditors

In each transaction there will be explicit and tacit added value created in both the present and the future. Let's focus on one transaction. We want to know the transfer price of recruiting a new employee. Recruiting a new employee adds value to the organisation. Why, because it doesn't simply recruit a person, but that new employee's network, experience, intelligence, personality, skills, and motivation.

Each of these things, as well as the chance that he would leave the organisation and the value his role has for the organisation in terms of his salary level, are taken into account in our calculation. We call these elements the variables and parameters of

the IC added value creating phenomenon. They produce our econometric formula, which looks like this:

| **Formula** | **Benefits - Costs** |
|---|---|
| | BENEFITS = Sum of (Multiplier x Average Earnings)<br>BENEFITS = Sum of (Network Multiplier x Experience Factor x (Intelligence Category x Intelligence Factor) x Personality Index x Social Skills Index x Technical Skills Index x Home Support Factor x Financial Backup Factor / Reference x Average Earnings)<br><br>Network Multiplier = (3 x (#A new + 0.8 x #A known) + 1.5 x (#B new + 0.8 x #B known) + (#C new + 0.8 x #C known)) x Persistence factor<br><br>COSTS = Sum of Average Earnings |

The figure above represents just a sample of the range of 77 formulae, containing 920 variables and parameters, which may be used in the determination of IC added value. The areas that are covered include, but are not limited to:

- experience transfer
- knowledge transfer systems
- learning organisation
- marketing and communications
- network transfer
- patents and development
- personality transfer
- presales support to SAs
- product development
- project development
- quality control
- sales channels
- structural human capital
- task transfer
- third party knowledge transfer
- unstructured internal IC

From this sample one can envisage that there are many possible phenomena and several econometric formulae, on a number of different levels, which may be used in the determination of IC added value. Then, each transfer pricing transaction consists of many elements of IC added value that are used to establish the total transfer price. Collectively at every level they cover the total transfer pricing value of an organisation.

## What is the key in the calculation of the IC added value for identifying transfer prices on the different levels?

One of the major problems encountered in any organisation is that some of the variables and parameters that are needed are not measured. For example: in the formula associated with the recruitment of a new employee, this person's network value is part of the equation. Unfortunately, in many organisations this value is not measured or, worse still, they have no idea of how to value it. So how could it be made work?

If we construct a comprehensive list of all existing networks, we would have 36 different ones. For each role an employee will fulfil, they are likely to only use some of them, usually the ones related to their actual role. So, let's say an employee in a certain role will use six network categories out of the possible 36. We start with a list of the people they know in each of those network categories. Then they are categorised according to the intensity of the relationship, from first time met through to one phone call away, and whether they are willing to use this relationship in their job or not. If we define a maximum score of, for example 5, then we can quantify each relationship based on intensity and willingness to use. Adding up all of these values, we arrive at a figure to include in the equation for the value of networks.

Having to do that for 920 variables and parameters is a demanding task. The time consuming part is not defining the econometric equations for the IC added value creating phenomena, but gathering the initial data in newly introduced measurement systems. Once that is completed, all measures have to be validated (they actually measure what they say they measure), statistically normalised and produce the same result when measured twice.

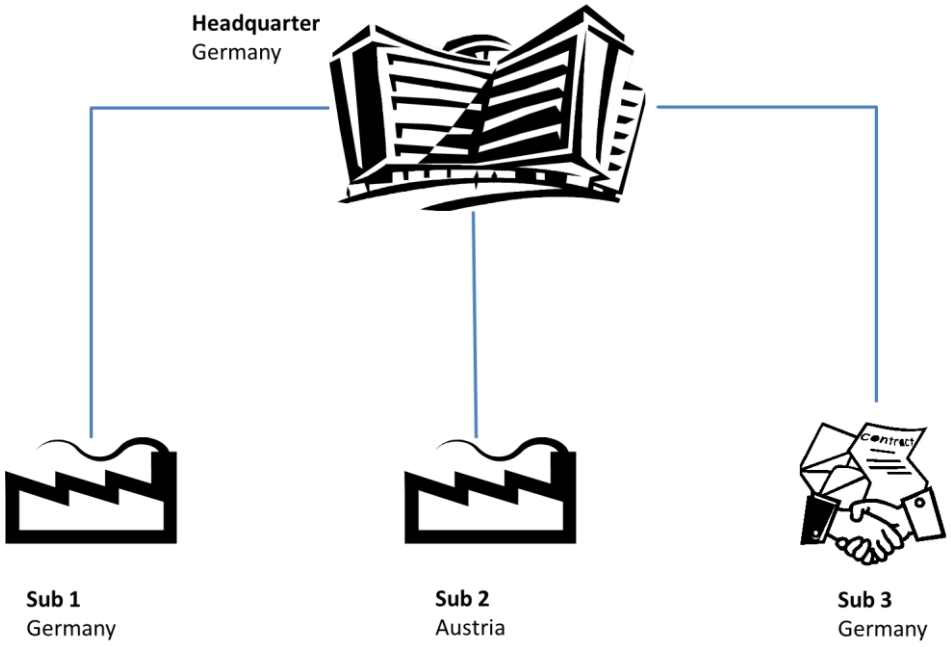
All this work has been done by Areopa during the last ten years. This new application in the area of transfer pricing is a breakthrough in the field of IC calculation, accounting and auditing thinking developed by Areopa.

The purpose of this white paper is to demonstrate how important it is to understand actual values, including the IC added value element, when looking to establish transfer prices. Tax regulations in relation to transfer pricing are established to prevent jurisdictional loss of revenue. While it may be useful to take into account the rules of the relevant tax regimes, it should be discouraged from the perspective of effective management of organisational units.

## An example from Germany

The following is a typical example of a situation found in organisations. We have a medium-sized German mechanical engineering group consisting of the headquarters and a production unit in Germany, a production unit in Austria, and a sales unit in Germany.

The group structure looks like this:

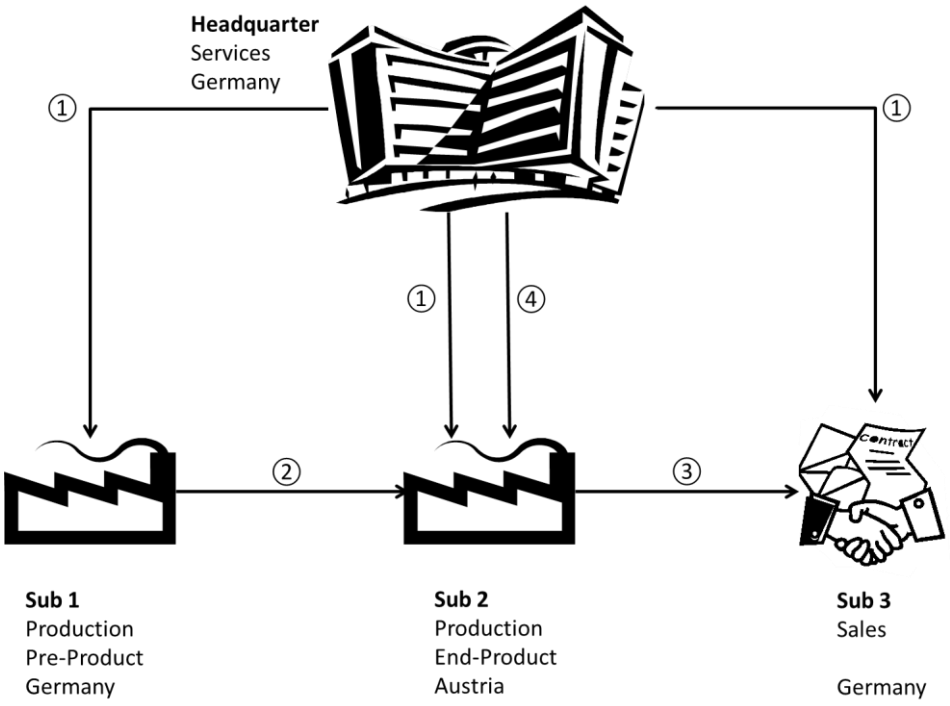



Between the units, there are various product and service relationships. Sub 1 is a manufacturer, which assembles a pre-product for Sub 2 where the end product is built. Distribution of the final product in all countries and markets is undertaken by Sub 3.

Headquarters is responsible for and provides to all units in the group companies all human resource activities, including payroll preparation, as well as IT services, including the SAP server. The product and service relationships are regular and are fixed by adequate agreements (SLAs).

In addition, headquarters provides another service to group units. Based on a decision by Group Management, a manager from headquarters has been sent to the recently bought Sub 2 in Austria to lead the PMI project.

The product and service relationships are shown in the following schematic,




and may be described in this way:

| | **Allocation Content** |
|---|---|
| (1) | Human resource service (Payroll etc.) |
| | IT service (SAP-Server) |
| (2) | Pre-product |
| (3) | End product |
| (4) | Special support - Interim manager for PMI |

Previously, the calculations for pricing the product and service relationships were established by using information from the "external", or financial accounting, records and allocated in the following way:

| | **Allocation Method** |
|---|---|
| (1) | Number of staff |
| | CPU minutes on SAP server |
| (2) | Number of pre-products delivered |
| (3) | Number of end products delivered |
| (4) | Number of days of service |

The transfer prices for products and services transferred between headquarters and the German subsidiary, Sub 1, on one hand, and the Austrian subsidiary, Sub 2, on

the other, are essentially determined by the tax regimes in Germany and Austria. The real values of the products and services transferred have not been considered in the calculation of transfer prices.

This situation is further evidenced by looking at the special service relationship - number (4). The transfer price for this relationship is determined according to the salary, payroll-related costs and other employment benefits, such as company car and pension contributions, for the assigned manager. If this manager negotiated an exceptional salary package the real value of his/her human capital is not taken into account when calculating the transfer price. Therefore, one can argue that the transfer price for this service relationship is more likely to be wrong rather than right.

Similar examples for other product and service relationships could easily be identified and explained.